

# **MANAGEMENT OF RECEIVABLES**

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# MANAGEMENT OF RECEIVABLES



# MEANING OF RECEIVABLES

- It is necessary for businesses to sell goods on credit because it helps maintain and increase the sales volume.
- Receivable comprises both Debtor and Bills Receivable.
- **Debtor**: Customers who have purchased goods on credit and have not paid the amount till the end of accounting year are Debtors or Account Receivables.
- **Bills Receivable**: The customers who have made credit purchase and have delivered the bills, hundi or promissory note for payment are known as Bills Receivables.

# **PURPOSE/OBJECTIVES OF RECEIVABLES**

1. **Increase in Sales:** A n enterprise, which provides the facility of credit sales, may sell more than what could be sold for cash only. The customers who do not even have cash for purchase could purchase if the credit facility is available.
2. **Increase in Profit:** Sales on credit increases profit in two ways
  - (a) profit margin in case of credit sales is always kept higher and
  - (b) additional profit is yielded by increased volume of sales.
3. **To meet the competition:** To compete with the rivals it is essential to provide credit facility to sell more than those rivals.

# COST ASSOCIATED WITH RECEIVABLE

1. **Capital Cost:** Since there is a sufficient time gap between credit sales made to customers and payment received from them, a sufficient amount of fund is tied up there. If the amount was received immediately it could have been employed somewhere else.
2. **Administrative Cost:** In case of credit sales, additional staff may be required for maintaining customers account, for examining credit standing of the customer etc. Other stationary expenses are administrative costs.
3. **Delinquency Cost:** Sometimes the customer fails to make the payment within due date. For that time period the company has to arrange funds from elsewhere, also, the company will have to send reminder, notices etc. to customer. Such costs are Delinquency cost.
4. **Collection Cost:** An enterprise has to pay several expenses in connection with the collection from former debtors/receivables. Such expenses incurred for collection of dues are called as collection cost. These include salary for employees engaged in collection, commission to the collection agencies.
5. **Default Cost:** When the customer fails to pay the amount due even after repeated reminders, such amount of debtor becomes bad debts and is known as default cost.

# **BENEFITS ASSOCIATED WITH RECEIVABLES**

1. **Increase in Sales:** Firm offers the option of credit sales in order to boost sales level.
2. **Profit Generation:** By making more sales a firm increases its profits substantially.
3. **Growth and Expansion:** With growth in sales and profits, a firm could think of growth and expansion of business.
4. **Customer Loyalty:** it also helps ensuring customer loyalty towards then firm.it is useful in retaining existing customers as well as attracting new customers.

# FACTORS AFFECTING THE SIZE OF RECEIVABLES

1. **General Factors:** Such factors include nature and form of business, volume of business, general economic conditions, availability of funds etc.
2. **Specific Factors:** These are the factors controlled by the firm.
  - i. **Level of credit sales:** If level of credit sales is high than receivables will be more
  - ii. **Credit terms:** if the firm has liberal credit terms, customers would be able to purchase goods easily. Whereas if terms are strict, costumers would not be able to purchase more on credit.
  - iii. **Terms of Sale:** if the firm decide not to sell in credit there will be no receivable.
  - iv. **Stability of Sales:** if the business is of seasonal nature, then the level of investment in receivable will increase and fluctuate in that season. Otherwise it will remain stable throughout the year.

# CREDIT POLICY

- A firm makes significant investment by extending credit to its customers and thus requires a suitable and effective credit policy to control the level of total investment in receivables.
- The basic decision to be made regarding receivable is to decide how much credit to be extended to a customer.
- Thus, the credit policy may be defined as a set of parameters and principles that governs the extension of credit to the customers.
- A sound credit policy includes well defined credit standards, credit terms, credit period, credit limit, cash discounts, collection period. Credit analysis must also be done.



# CREDIT STANDARDS

Credit Standards provide a base for deciding whether to grant credit to a customer or not. Credit Standards represents the basic conditions for offering credit to customers. These could include credit standing of the customers, credit reference etc. Credit Standard could be

1. Tight Credit Standards – less credit will be extended.
2. Liberal Credit Standards – More credit can be extended easily.

# **CREDIT ANALYSIS**

An enterprise will never sell goods blindly to all customers. It has to evaluate and examine the ability of customers to make payment as per the promise. The financial position and creditworthiness of the customer must be evaluated before extending credit sales. Credit analysis has 3 aspects

1. **COLLECTION OF INFORMATION ABOUT THE CUSTOMER.**
2. **ANALYSIS OF COLLECTED INFORMATION**
3. **DECISION OF CREDIT SALES**

# **COLLECTION OF INFORMATION ABOUT THE CUSTOMER.**

Collection of information about the customer can be obtained from

1. Financial Reports
2. Credit rating agencies
3. Trade references
4. Bankers enquiries
5. Market reports
6. Own experience

# ANALYSIS OF COLLECTED INFORMATION

Analysis of collected information on the basis of

1. Character: Willingness of the customers to make payment. This can be judged from past records.
2. Capacity: This is ability of the customer to pay and can be judged by amount of capital, financial position etc.
3. Capital: This is determined by the cash inflow of the customer.
4. Conditions: there are certain economic circumstances, which might have an effect on the customer's ability to pay.
5. Cost: Refers to the amount of credit sales made to the customer.
6. Collateral: if the customer fails to pay, he has any collateral or not.

# CREDIT TERMS

- After setting up credit standards and analysing customers creditworthiness the company has to decide terms and conditions on which credit facility will be made available to customer. These terms and conditions are known as credit terms.
- It has three major component
  - a. Credit Period
  - b. Cash Discount
  - c. Discount Period

# **CREDIT PERIOD**

- CREDIT PERIOD refers to the length of time over which the customers are allowed to delay the payment. The credit period generally varies from 3 to 60 days.
- When credit period is more than sales increases by attracting more and more customers.
- And higher credit period implies more investment in receivables.

# CASH DISCOUNTS

- Cash discounts are provided to encourage customers to make prompt payments.
- Here, cash discount does not mean reduction in price. Through cash discount benefits are provided to those customers who are ready to pay early.
- Different discount rates may be offered to different period.  
E.g. 3% discount if the payment is made within 10 days.
- Cash discount of 2/20 net 30 means
  - 2% discount if the payment is made within 20 days. Otherwise full payment after 30 days from the date of sale.

# CASH DISCOUNT PERIOD

- A cash discount period is the time period allowed to the debtors within which the debtors are encouraged to pay their dues to avail cash discount.
- 2/20 net 30 means
  - 2% discount if the payment is made within 20 days. Otherwise full payment after 30 days from the date of sale.  
Here, Cash Discount period is 20 days.



## **CREDIT LIMIT**

Sometimes a firm may decide as to up to what extent credit facility will be provided to an individual customer. Such ceiling on the amount of credit to be provided to the customer is called **Credit Limit**.

## **COLLECTION PERIOD**

The period within which collections are to be made from the customers.

# MANAGEMENT OF PEEEYABLES



# **MANAGEMENT OF PAYABLES/CREDITORS**

- Trade credit is important for the business in the sense that it allows firms to get immediate supplies on credit.
- Management of payables is important because slow payments to the creditors may create a bad image of the firm.

# **COST OF TRADE CREDIT**

Normally it is considered that the credit does not carry any cost but it does have following costs

1. **Implicit cost of availing discount:** discount can only be availed if the firm makes early payment. This would certainly involve some implicit cost.
2. **Loss of goodwill:** if the firm uses more trade credit and fails to pay on the due date. It will certainly lose its reputation in the market.
3. **Cost of managing:** management of creditors involves administrative and accounting cost.
4. **Conditions:** sometimes suppliers put conditions for availing trade credit that order should be of some minimum size or on regular basis. This involves extra cost.

# **BENEFITS OF TRADE CREDIT**

1. **Reduced capital requirement**: This means that if a new business setting up has trade credit, they will obviously require less money in capital to start up the business.
2. **Improves cash flows**: There is no immediate cash outflow in availing trade credit. Thus, Trade credit improve the cash flows and therefore, provide smoother operation for the business.
3. Businesses can **buy now and pay later** which means even if they don't have the money at first they can purchase items.
4. With trade credit, the **business can focus on other areas** such as sales, marketing and research rather than worrying about paying the bills.

# MANAGEMENT OF INVENTORY



# **MANAGEMENT OF INVENTORY**

- Inventory is one of the important component of current assets.
- Inventory explains the stock of goods the firm has either in the form of raw material, spare parts, work in progress/semi-finished goods and finished goods.
- Effective inventory management would ultimately aim at maximization of the owner's wealth, which is consistent with the overall objective of financial management.

# **COMPONENTS OF INVENTORY**

1. **Inventory of Raw Material**: Various types of raw materials which are used in production process.
2. **Inventory of Store and Spare Parts**: This inventory consist of those products which serves as accessories to the main products. Bolts, nuts, screws etc. are example of spare parts.
3. **Inventory of Work-in-Progress**: Manufacturing processes involves various processes for converting raw materials into finished goods. As such some material might have been issued to the production process but might not have been completed as finished goods. This is known as work-in-process.
4. **Inventory of Finished Goods**: All goods manufactured during the period may not be sold immediately. They are Finished goods and are kept in warehouse.



# **BENEFITS/PORPOSE OF HOLDING INVENTORY**

1. **Benefit in selling as per demand**: if goods ready for sell are not kept in the business the business concern would lose the opportunity to sell. Having sufficient inventory helps the firm meet the customer demand.
2. **Benefits of quantity discount**: Purchasing raw materials in large quantities helps the firm to avail discounts. This reduces the cost of acquiring and ordering inventory.
3. **Reduction in ordering cost**: When the firm is able to hold more inventory, it could purchase more raw material in large quantity. This reduces the cost of acquiring and ordering inventory
4. **Benefit in Production**: if the firm is having sufficient inventory of raw material production process will be smooth and continuous. Continues production lowers down the cost of production.
5. **Reduction in risk of production shortage**: manufacturing concerns frequently produce goods in large number. If sufficient inventory is not available production would be halted and would result in heavy losses.

# **RISKS/COST OF INVENTORY**

1. **Material Cost:** These are the cost of purchasing the raw material/merchandise and include all types of transportation and handling costs also.
2. **Ordering cost:** these are costs incurred for acquiring or ordering the inventory. The costs linked with it are the fixed costs like preparing purchase orders, receiving, inspecting, re-ordering as per the purchase order etc.
3. **Carrying Cost:** When ordered goods are materials are received by the concern are inspected, these are not immediately sold or converted into finished goods. They are stored for certain period. Carrying cost include maintaining cost, storing cost, holding costs, insurance of inventory etc.
4. **Obsolescence:** Holding large amounts of inventory over a longer period of time might also lead to obsolescence.

# INVENTORY CONTROL TECHNIQUES

- Economic Order Quantity (EOQ) Analysis
- Re-order Point
- Safety Stocks
- A.B.C. Analysis Always Better Control
- H.M.L. Analysis: High, Medium, Low
- F.S.N. Analysis: Fast moving, Slow moving, Non-Moving
- V.E.D. Analysis: Vital, Essential, Desirable

# ECONOMIC ORDER QUANTITY

- The Economic Order Quantity model attempts to determine the order size that will minimize the total inventory cost i.e. and total ordering cost and total carrying cost

$$EOQ = \sqrt{\frac{2AO}{C}}$$

**A = Annual requirement**

**O = Ordering cost per unit**

**C = Carrying cost per unit**

**Total inventory cost = total ordering cost + total carrying cost**

$$\text{Total ordering cost} = \frac{AO}{Q}$$

$$\text{Total carrying cost} = \frac{QC}{2}$$

**A** = Annual Requirement

**O** = Ordering Cost per Unit

**Q** = Economic Order Quantity

- Re-order Point =  $E+(S \times L)$  (When Safety Stock is there)
- Re-order Point =  $(S \times L)$  (When safety stock is not there)

E = Safety stock

S = Average usage

L = Lead time

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